

RICHARD HUGH BAKER

6TH DISTRICT, LOUISIANA

COMMITTEE ON
FINANCIAL SERVICES

CHAIRMAN
SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT

SUBCOMMITTEE ON
INTERNATIONAL MONETARY POLICY
AND TRADE



Congress of the United States

House of Representatives
Washington, D.C. 20515-1806

March 26, 2003

COMMITTEE ON
TRANSPORTATION AND INFRASTRUCTURE

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SUBCOMMITTEE ON HEALTH

The Honorable William H. Donaldson
Chairman
Securities And Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Dear Chairman Donaldson:

As you know, one of the highest priorities of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises is to help restore confidence in our securities markets. An essential component of that goal is our ongoing review of mutual funds, and our efforts to promote transparency, accountability, integrity, and competition in that industry.

At the Subcommittee's recent hearing on mutual funds, a majority of witnesses raised concerns about the level and transparency of fees, and other issues affecting investors. Mr. Gary Gensler, author of The Great Mutual Fund Trap, observed that "mutual funds have constructed a system where the costs are practically invisible." Mr. John Bogle, founder and former chief executive of the Vanguard Group, stated that "investors are largely unaware of the high level of mutual fund costs," and that "since managers have an obvious vested interest sustaining this ignorance...we urgently need new SEC rules that require greater cost disclosure." And Mr. John Montgomery, Bridgeway Funds founder, cited a news report that said: "Mutual funds exist in a culture that thrives on hype and withholds important information in a cutthroat business that regularly misleads investors." In stark contrast, Mr. James Riepe, chairman of T. Rowe Price Funds, testified that mutual fund "investors get all the information they need to make an intelligent decision."

I am troubled that there may be insufficient transparency of mutual fund fees, costs, and operations. I am also concerned about mutual fund governance and the performance of fund directors, fund distribution practices, and other matters. For each of the issues set forth below, please provide the Commission's views, including any recommendations for legislative and/or regulatory actions. Also, for each of the issues, please discuss its impact on investors. Please provide this information by June 11, 2003.

Transparency of fees and costs

1. The GAO recently issued another study indicating that fees for actively managed equity funds have risen in recent years. Similarly, the Commission's 2000 study also concluded that mutual fund fees were rising. At the subcommittee hearing, Mr. Bogle suggested that the GAO report actually underreported the extent to which fees have increased. This upward trend in fees suggests that competitive forces are not driving fees down. What steps might help promote greater transparency of fees for investors, and greater fee-based competition among funds? Please assess the relative utility of information provided on shareholder statements and semi-annual shareholder reports versus the prospectus and statement of additional information.
2. Several witnesses testified about the opacity of portfolio trading costs. Mr. Montgomery stated that his funds obtain an independent review of their trading costs, and make that report available to the funds' board of directors, but not to investors, for competitive reasons. However, he stated that if all funds disclosed such data, they would be "willing and happy to do so." This indicates that trading cost information is certainly relevant as well as calculable, given that at least one fund obtains this data and provides it to its directors. Please provide an analysis of how trading costs could be better disclosed to investors, including an analysis of the relative utility of including commissions and other trading costs in the fund's expense ratio or as a separately disclosed cost item.
3. Mr. Montgomery stated that "apart from affiliated brokerage and directed brokerage, the practice of soft dollar commissions is one of the worst examples of undisclosed conflicts of interest in the mutual fund industry." Please discuss how soft dollar arrangements create undisclosed conflicts of interest and whether enhanced transparency and disclosure of actual execution costs would benefit investors.

Portfolio manager information

4. Please discuss whether disclosing the structure of portfolio manager compensation might benefit investors.
5. In light of the fact that fund directors' holdings of fund shares is disclosed to investors, it would seem to make sense that the same information about portfolio managers' holdings of fund shares would be just as important to disclose to investors. Please discuss whether investors would benefit from having the same information about portfolio managers.

Mutual fund governance

6. Please provide an analysis of the current definition of independent ("disinterested") directors under the Investment Company Act of 1940, including a discussion of the adequacy of that definition. Additionally, please discuss whether directors are adequately serving fund shareholders' interests, including oversight of fund fees. In particular, please address the impact of requiring the chairman of the board of a fund to be disinterested.

7. Please describe the Commission's expectations regarding the role of fund directors in the failure by numerous fund groups to provide "breakpoint" discounts to customers as promised in the funds' prospectuses.

8. Please discuss the frequency of rejection of management contracts by fund directors in the past ten years.

9. Please discuss the legal standard that applies to the fiduciary obligations of fund directors and advisers with respect to approval of management contracts, and issues relating to the utility of that standard in light of your response to question number 8. Please discuss the effectiveness of the Commission's new rules requiring disclosure in the Statement of Additional Information of the board's rationale for approving management contracts, including an analysis of possible alternative disclosure venues for providing this information to investors.

10. Section 301 of the Sarbanes-Oxley Act directs the Commission to require the stock exchanges to prohibit the listing of any security of a public company that does not have an audit committee meeting certain criteria. Because only closed-end funds and certain exchange-traded open-end funds are listed on stock exchanges, this provision does not apply to most open-end investment companies. Please discuss whether mutual fund investors would benefit from similar corporate governance reforms.

Fund distribution issues

11. Please describe the obligations of fund directors regarding approval of distribution arrangements under Rule 12b-1 and otherwise. Please discuss whether the rule should be updated in light of the evolution of fund distribution since the rule's adoption.

12. I understand that investment advisers to funds make so-called "revenue-sharing" payments to facilitate distribution of fund shares. One commentator has estimated that, in 2000, fund sponsors paid brokers as much as \$2 billion to obtain distribution benefits – roughly four times the amount funds paid for advertising. This commentator described revenue-sharing as "the dirty little secret of the mutual fund industry...Nobody likes to talk about it, but the reality is that it has become a major expense." Please describe how these arrangements work, the impact of these expenses on investors, the legal issues raised by such arrangements with respect to Rule 12b-1, directors' obligations with respect to these arrangements, and the transparency of these arrangements and their associated costs.

Performance information

13. Many investors select mutual funds based on past performance, although numerous studies have demonstrated that investing in funds based on past performance does not improve the likelihood of obtaining good performance going forward. Please discuss what steps can be taken to help educate investors on this subject and improve the utility of information on which fund investors base their investment decisions. Please discuss how fund advertising contributes to this phenomenon.

14. Please discuss whether shareholder reports, on average, adequately disclose the factors affecting fund performance.

15. Please discuss the practice of steering hot IPOs to “incubator” funds and then using those funds’ performance data as a marketing tool.

Mutual funds and IPOs

16. Please discuss the legal and policy implications of potential use of mutual funds by their broker-dealer affiliates to prop up prices of IPOs in the secondary market.

Proxy voting


17. I congratulate the Commission once again for adopting new rules requiring disclosure of mutual fund proxy voting. I am concerned, however, by industry efforts to block the implementation of this important reform by intervening in the OMB’s routine review of the rules. Please provide the Commission’s analysis of whether the benefits to investors of this enhanced transparency merit the burdens and costs to industry, and an estimation of what those burdens and costs will be.

Valuation

18. The Commission staff recently indicated that it would recommend enforcement proceedings against a mutual fund company for failing to properly value private holdings of the firm’s mutual funds. Please discuss the issues raised by portfolio security valuation methodologies and the relevant rules relating to those methodologies. In particular, please discuss the rules applicable to, and issues raised by, valuation of private securities as well as those relating to fair value pricing of securities for which a market price is available. Please discuss the extent to which pricing is done by third-party, arms’ length independent appraisers and how the discount for large-bloc positions is determined.

I appreciate the opportunity to continue to work with you to restore investor confidence in the capital markets, and look forward to your response.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard H. Baker". The signature is fluid and cursive, with the first name "Richard" and last name "Baker" clearly distinguishable.

Richard H. Baker
Chairman
Subcommittee on Capital Markets,
Insurance, and Government Sponsored Enterprises